

Internal Revenue Service
memorandum

CC:TL-N-6962-91

Br4:GBFleming

date: JUN 28 1991

to: District Counsel, [REDACTED] SE: [REDACTED]
Attention: [REDACTED]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Tax Litigation Advice -- [REDACTED]

This responds to your memorandum dated May 7, 1991, requesting tax litigation advice regarding the recapture of intangible drilling and development costs (IDC) pursuant to I.R.C. § 1254 in the case of the above-referenced taxpayer.

ISSUE

Whether the rule set forth in *Golsen v. Commissioner*, 54 T.C. 742 (1970), requires the Service to follow the holding in *Houston Oil & Minerals Corp. v. Commissioner*, 92 T.C. 1331 (1989), *aff'd*, 922 F.2d 283 (5th Cir. 1991), for this taxpayer with respect to the recapture of IDC under I.R.C. § 1254.

FACTS

The taxpayer, [REDACTED] ([REDACTED]), and its subsidiaries are engaged in various activities, including the development and operation of oil and gas properties. In particular, in [REDACTED]'s wholly owned second tier subsidiary, [REDACTED] ([REDACTED]) owned working interests in partially developed and undeveloped oil and gas properties located in federal waters offshore Louisiana, Texas and California. On [REDACTED], [REDACTED] carved out an overriding [REDACTED] percent net profits interest from its working interests in those offshore properties and conveyed the carved out interest to its parent, [REDACTED] ([REDACTED]), a wholly owned subsidiary of [REDACTED]. [REDACTED] retained and continued to operate the working interests in the offshore properties.

[REDACTED] obtained a nonrecourse loan of \$ [REDACTED] to be repaid from the proceeds of the net profits interest, which was the only security for the loan. Subsequently, [REDACTED] distributed the net profits interest to [REDACTED] as a dividend. After receiving the net profits interest, [REDACTED] joined with [REDACTED], a wholly owned subsidiary of [REDACTED], to form a general partnership to collect and distribute the proceeds from the net profits interest. [REDACTED] held a [REDACTED] percent interest in the partnership, which it placed in the [REDACTED]. The Trust was created as a grantor trust for the purpose of

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receiving distributions from the partnership and to distribute the net cash receipts to the unit holders of the Trust. [REDACTED] distributed the Trust units pro rata to its shareholders.

The end result of the foregoing series of transactions was to transfer the carved out [REDACTED] percent net profits interest from the [REDACTED] consolidated group to the partnership, with [REDACTED]'s [REDACTED] percent of the partnership interest assigned to the Trust, in which [REDACTED]'s shareholders held the units of beneficial interest. Prior to carving out the [REDACTED] percent net profits interest, [REDACTED] had previously deducted IDCs with respect to some, if not all, of the operating mineral interests from which the net profits interest was carved.

DISCUSSION

This is another in a series of cases raising the IDC recapture issue in the context of transfers of nonoperating interests in oil and gas properties to royalty trusts. The Tax Court, the Fifth Circuit and the Claims Court have previously held that I.R.C. § 1254 does not require recapture of IDC in such transactions. *Houston Oil & Minerals Corp. v. Commissioner*, 922 F.2d 283 (5th Cir. 1991), *aff'g* 92 T.C. 1331 (1989);^{1/} *Southland Royalty Co. v. United States*, 22 Cl. Ct. 525, 91-1 USTC (CCH) ¶ 50,083 (1991). Each of those cases involved a situation in which the taxpayer carved nonoperating interests out of operating interests with respect to which IDCs were previously deducted, transferred the nonoperating interests to a grantor trust, and distributed units in the trust to its shareholders.

Although [REDACTED]'s case involves a more complicated sequence of intermediate transactions, the recapture issue is essentially identical to the issue decided in *Houston Oil & Minerals Corp.*, *supra*, and *Southland Royalty Co.*, *supra*. In *Houston Oil & Minerals Corp.*, the Fifth Circuit affirmed the Tax Court's holding that the disposition of a nonoperating mineral interest in tax years beginning before 1987 does not induce recapture of IDCs under I.R.C. § 1254. Although we believed that our litigating position was correct, we did not recommend filing a petition for writ of certiorari due to the absence of a conflict between the courts of appeal. The Tax Division concurred, and the Solicitor General decided not to seek a writ of certiorari.

In *Southland Royalty Co.*, *supra*, the Claims Court reached the same conclusion as the Tax Court and Fifth Circuit reached in *Houston Oil & Minerals Corp.* In an effort to obtain a conflict between circuit courts, we recommended an appeal to the Federal Circuit, and the Tax Division also endorsed an appeal. We have been informed, however, that on June 4, 1991, the Solicitor General decided not to prosecute the appeal.

In *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court enunciated the principle that "where the Court of Appeals to which appeal lies has already passed upon the issue before us, efficient and harmonious judicial administration calls for us to

^{1/} Contemporaneous with its opinion in *Houston Oil & Minerals Corp.*, the Tax Court reached the same result in a virtually identical opinion in *Louisiana Land & Exploration Co. v. Commissioner*, 92 T.C. 1340 (1989).

follow the decision of that court." 54 T.C. at 757. Under the *Golsen* rule, the Tax Court will ordinarily follow a previously announced rule of the appellate court to which appeal lies even if the appellate court's rule is contrary to the Tax Court's view on the issue under consideration.


Because [REDACTED]'s principal place of business is located in [REDACTED] Louisiana, an appeal of any Tax Court decision with respect to [REDACTED]'s tax liability related to the carved out net profits interest would lie in the Fifth Circuit. In such a case, the *Golsen* rule would require the Tax Court to follow its own decision in *Houston Oil & Minerals Corp.*, which the Fifth Circuit has affirmed. Because the Fifth Circuit would generally be bound by its decision in *Houston Oil & Minerals Corp.*, there would be no point in litigating the IDC recapture issue again in that forum.

Under these circumstances, we believe that it is appropriate to concede the IDC recapture issue with respect to [REDACTED]'s [REDACTED] tax year. If there were a possibility of obtaining an intercircuit conflict and ultimate review of this issue by the Supreme Court, we would be reluctant to recommend concession in this case at this time. The Solicitor General's decision not to pursue an appeal in *Southland Royalty Co.*, however, virtually forecloses any possibility of litigating this issue further. For that reason, we intend to prepare an Action on Decision announcing acquiescence in *Houston Oil & Minerals Corp.* and endorsing the Tax Court's dicta to the effect that the result would be different after the changes in section 1254 effected by the Tax Reform Act of 1986. Accordingly, for tax years commencing after January 1, 1987, we would maintain (where applicable) that these type of transactions trigger IDC recapture. However, since it is now virtually impossible to obtain a conflict between jurisdictions (*viz.*, the Claims Court allows taxpayer suits without regard to venue), the most prudential course of action is to concede the IDC recapture issue in this and other similar cases.

Please contact Gerald Fleming at FTS 566-3345 if there are any questions.

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